



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

CM #113

April 6, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Lawrence A. Kudlow *EM for LAK*

SUBJECT: Federal Credit Working Group Update

The Federal Credit Working Group update addresses three separate issues:

- o A request by the National Credit Union Administration (NCUA)/Central Liquidity Fund (CLF) for Treasury approvals with respect to the proposed issuance of notes.
- o Rechartering the Federal Home Loan Mortgage Corporation (FHLMC) as a privately-controlled stock corporation.
- o A report on credit initiatives in the 1983 budget, some analytical points of interest and the future agenda of the Working Group.

I. NATIONAL CREDIT UNION ADMINISTRATION (NCUA) AND CENTRAL LIQUIDITY FACILITY (CLF)

NCUA/CLF Borrowing

Background. The Central Liquidity Facility of the National Credit Union Administration (CLF) has requested that the Treasury (1) designate CLF securities as exempt from certain regulations under the Securities Exchange Act of 1934 and (2) approve the use of CLF securities as collateral for deposits of public monies and for Treasury tax and loan accounts. The purpose of these requests is to facilitate NCUA marketing of securities to private investors on behalf of CLF. CLF has been borrowing from the Federal Financing Bank (FFB) since 1978, when CLF was established within NCUA. Under the FFB Act the FFB is authorized to purchase obligations that are issued, sold or guaranteed by a Federal agency. However, it has been determined that CLF obligations are not backed by the full faith and credit of the U.S. and that, consistent with current FFB policy, such obligations should thus be financed in the market rather than through the FFB.

The approvals that CLF now seeks are granted generally on the basis of the safety of the securities as investments. In the absence of full Federal backing for CLF securities, however, investors, must rely solely on the resources of the NCUA and CLF for payment of the obligations. There is a significant element of risk to the investor that could be obfuscated by the appearance of Federal backing that would be implied if Treasury approved NCUA's requests.

While certain Government-sponsored enterprises, such as FNMA, FHLMC, and the FHLB and Farm Credit systems, now have the privileges sought by NCUA, denial of the NCUA requests would be consistent with the general policy statements in the February Budget documents regarding the privatization of Government-sponsored enterprises and cutting their ties to the Government. In fact, it is anticipated that, as the privatization of the other agencies progresses, they too will lose these privileges.

The attached letter to Chairman Callahan of NCUA indicates Treasury's decision not to grant the requested approvals.

It is likely that the CLF will pay higher interest rates than other agency issuers as a result of this decision. In fact, CLF may well be restricted to only short-term borrowing in the market.

Recommendation: That the CCEA authorize Treasury to send the attached letter.

Approve _____

Disapprove _____

Attachment

**DEPARTMENT OF THE TREASURY****WASHINGTON, D.C. 20220****ASSISTANT SECRETARY**

Dear Mr. Callahan:

This is in reply to your letter requesting that the Treasury provide several approvals with respect to the proposed issuance of notes in the market by the National Credit Union Administration (NCUA) on behalf of the Central Liquidity Facility (CLF).

Specifically, the NCUA requests: (1) Treasury approval under 31 CFR 202.6, 203.15 of the use of NCUA/CLF securities as collateral for deposits of public monies and for Treasury Tax and Loan Accounts; (2) designation under 15 USC 78c(a)(12) of NCUA/CLF notes for exemption from regulation under the Securities Exchange Act of 1934; (3) Treasury approval under 12 USC 2286 of NCUA market financing plans; and (4) a waiver by the Federal Financing Bank (FFB) of the priority of the United States under 31 USC 191 in the event of NCUA/CLF's insolvency.

Treasury designations of securities as eligible to collateralize public deposits and as exempt under the Securities Exchange Act are based generally on the safety of such securities as investments. In the absence of full Federal backing for NCUA/CLF securities, investors must rely solely on the resources of the NCUA and the CLF for payment on the obligations. These resources include the capital contributions of member credit unions and the loans made by the CLF to meet the liquidity needs of credit unions, some of which are authorized to be made in emergency circumstances. Reliance on the resources of the NCUA and CLF could entail a significant element of risk, which could be obfuscated by the appearance of Federal backing that would be implied by an exemption under the Securities Exchange Act and the use of the CLF obligations as collateral for government deposits in financial institutions. Thus, we must deny these two requests. We recognize, however, that this denial would not apply to certain short-term securities which may be exempt from SEC regulation under the 1934 Act without Treasury designation.

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With regard to Treasury approval of NCUA/CLF market issuance, we anticipate no difficulties in providing Treasury approval. As your specific marketing plans develop, my staff will be happy to cooperate with your staff in granting Treasury approval of the timing, interest rate, and other substantial terms of each sale of NCUA/CLF securities.

As to the waiver of the FFB's priority with respect to CLF debt, we do not believe that this would be consistent with 31 USC 191, which provides that the United States shall generally enjoy priority over other creditors upon the insolvency of any person indebted to the United States. Such a waiver would be contrary to the public interest in that it could lead to losses to the FFB, and thus to the Treasury, in the event of default by the CLF. Consequently, we are unable to grant this request.

Please let me know if you have any questions or if I can be of any further assistance.

Sincerely,

Roger W. Mehle

Mr. Edgar F. Callahan
Chairman
National Credit Union
Administration
Washington, D.C. 20456

II. FHLMC RECHARTERING LEGISLATION

The Federal Home Loan Mortgage Corporation (FHLMC) has submitted legislation (S. 1805) to Congress to recharter FHLMC as a privately-controlled stock corporation and expand its activities. FHLMC would retain ties to the Government but would greatly expand its capital and borrowing bases and its role as an issuer and guarantor of mortgage-backed pass-through securities.

The general purpose of S. 1805 is in keeping with the Administration's basic policy statements in the February Budget documents regarding the privatization of Government-sponsored enterprises, but several amendments to the bill will be necessary to assure conformity to the Administration's broad policy objectives and to deal with specific concerns of various agencies. Agency views on the bill have been gathered by OMB, and FHLMC is amending its bill to accommodate the Administration's concerns.

The attached Treasury letter to FHLMC suggests some basic guidelines to be followed in privatizing FHLC and discusses specific Treasury concerns with the bill. The Working Group will review the revised bill and submit to the CCEA its recommendations as to the Administration's position.

**DEPARTMENT OF THE TREASURY**

WASHINGTON, D.C. 20220

Assistant Secretary

March 12, 1982

Dear Phil:

Your letters of February 2 and 3 regarding your proposed FHLMC Charter Act (S. 1805) raised a number of broad policy issues regarding FHLMC's future relationship to the Government, its competitive position in the private market, and its competitive position vis a vis FNMA. We have also been furnished a copy of FNMA's February 4 letter to FHLMC which addresses these same policy issues in considerable detail. These issues have been carefully considered by the Cabinet Council on Economic Affairs and were addressed in the following policy statement in the Budget submitted to Congress by President Reagan on February 8, 1982:

"Privatization of Government-Sponsored Enterprises

If their current links to the Federal Government are continued, the Government-sponsored enterprises should also be brought under closer scrutiny through the budget and credit budget process. The Administration prefers, however, to modify the special relationship between these enterprises and the Federal Government in order to transform them into completely private organizations. In particular, the Administration seeks to accelerate the development of a truly private secondary market for housing finance. Both the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA) will be active in guaranteeing conventional mortgage-backed securities in the coming year, and it is expected that both institutions will be strongly supported by the expansion of private mortgage insurance activity. Moreover, it is anticipated that the competitive advantages now accorded to FHLMC and FNMA will be gradually eliminated." (p. 199 of the "Major Themes" book).

I know that you and FNMA are in fundamental agreement with this basic policy of the Administration. The alternative of Federal budgetary control over FHLMC and FNMA is as unacceptable to you as it is to us. Yet no organization can be expected to function effectively without an external discipline, and if that discipline is not provided by the political budget process then it must be provided by the competitive market process. The compromise represented by the so-called quasi-Government corporation -- with freedom from Federal budget constraints but with various

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explicit and implicit forms of Government support and privileges to protect it against competitive market forces -- is no solution at all. The concept of effective market competition between two Federal agencies or two Federally subsidized agencies is, of course, absurd. In this spirit, we applaud your efforts in S. 1805 to seek further privatization of FHLMC and in time to break all links with the Federal Government. We are in agreement with your ultimate goal of complete privatization, and we feel that S. 1805 must be a giant step in this direction.

The problem, of course, is the transition period and the need, which you recognize, to provide for some reasonable competitive balance between FHLMC and FNMA -- the so-called "level playing field" -- as they move toward their ultimate goal. This will not be easy. The fundamental differences in the history, financial position, and structure of the two institutions are too great to permit their being placed on an equal footing during the transition period. This is a major reason why the transition period must be short. The longer we temporize, the greater the pressures to retain or provide more Federal benefits and thus more Federal controls.

Clearly, we should not attempt to achieve equity between FNMA and FHLMC by granting each institution all of the special Federal subsidies, protections, and exemptions, enjoyed by the other. This would be a step backward, toward more Federal dependence. Similarly, if we resist the elimination of certain benefits enjoyed by one institution until such time as the benefits are eliminated for the other institution, no progress will be made.

Nor will we achieve our purpose by invoking Federal supremacy and exempting either institution from the laws of the various States. We seek to achieve competition not just between FNMA and FHLMC but also with other private institutions in the housing and mortgage markets, which are subject to State laws.

The approach must be to phase out both Federal controls and special privileges and exemptions as soon as practicable, and at every opportunity, and to avoid providing any new such benefits that would be contrary to our underlying purpose of achieving financial independence.

With regard to Treasury's particular tax and debt management concerns, we continue to feel that the authority in section 4(f) of the bill for FHLMC to designate any Federal Reserve Bank to act as its fiscal or paying agent should be

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subject to the approval of the Secretary of the Treasury. While the bill does not specifically require the Federal Reserve Banks to provide services if they were designated to do so by FHLMC, there would appear to be no question as to the intent of Congress that they do so. Rather than establish by statute a presumption that Federal Reserve Bank facilities should continue to be available there should be flexibility to terminate the use of such services at an appropriate point in FHLMC's transition from a Government-sponsored enterprise to a completely private institution.

As to the provisions in section 12(a) of the bill which would exempt FHLMC and its securities from SEC regulation under the Securities and Exchange Acts of 1933 and 1934, we understand your concern that after the transitional period provided in the draft bill FHLMC may not be able to obtain a SEC "no action" letter because FHLMC would not be "controlled or supervised....by the United States". Yet as FHLMC becomes a completely private entity the appropriateness of SEC exemptions would come into question.

We have discussed FHLMC's tax proposals with Treasury tax officials. You noted that the Treasury supported tax relief for FNMA in the form of application of longer tax loss carry back rules. This measure is intended to deal with serious losses suffered by FNMA and is consistent with the Administration's overall approach of moving in the direction of treating Government-sponsored agencies like other private financial institutions. FNMA, unlike FHLMC, has been subject to Federal income taxes since it became a wholly privately-owned institution in 1968 and before that FNMA was required to make payments in lieu of Federal taxes and to pay to the Treasury a pro rata share of its earnings while it was a mixed-ownership corporation.

I understand that the Office of Management and Budget is soliciting the views of various interested agencies on S. 1805 with regard to overall housing policy, civil service and labor laws, Federal-State relations, and other matters, including the particular concerns of the Treasury regarding tax and debt management questions. Thus, while the Treasury supports S. 1805, with certain modifications we discussed, we would want to refine our suggestions in light of the views of other agencies as we participate in the development of the Administration's proposed amendments to the bill. I assure you that I will attempt to expedite this process.

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I hope these comments are helpful. I look forward to working with you on S. 1805 toward the achievement of our mutual objectives.

Sincerely,



Roger W. Mehle

Mr. Philip R. Brinkerhoff
President
Federal Home Loan Mortgage
Corporation
1776 G Street, N.W.
Washington, D.C. 20013

III. FEDERAL CREDIT BUDGET SCORECARD**A) Policy Decisions**

- 1) Significant progress has been made in reducing direct loans. The 1983 budget proposed an \$8.2 billion reduction in on-budget direct lending, principally in the areas of CCC price supports, GNMA tandem purchases, rural housing, and FmHA loan asset repurchases.

MAJOR CHANGES IN FEDERAL CREDIT: 1982-1983
(in billions of dollars)

	<u>1982</u>	<u>1983</u>	<u>Change</u>
<u>Direct Loans</u>			
<u>On-Budget:</u>			
Foreign military sales credit...	0.8	1.7	+1.0
Economic support fund.....	0.2	0.9	+0.7
Export-Import Bank.....	4.4	3.8	-0.6
CCC price supports.....	8.6	6.6	-2.0
Agriculture credit.....	2.1	3.7	+1.6
GNMA mortgage purchases.....	2.0	---	-2.0
Rural housing.....	3.7	1.1	-2.6
Student loans.....	0.6	0.5	-0.1
FmHA loan asset repurchases.....	9.3	6.7	-2.5
Elderly housing.....	0.8	0.5	-0.3
NCUA.....	0.3	0.5	-0.2
SBA.....	1.4	1.0	-0.4
Rail programs.....	0.1	---	-0.1
Other independent agencies.....	<u>5.6</u>	<u>4.8</u>	<u>-0.8</u>
Subtotal, on-budget direct loans.....	39.9	31.8	-8.2
<u>Off-Budget:</u>			
Federal Financing Bank:			
Foreign military sales credit	2.7	3.7	+1.0
SLMA.....	0.7	---	-0.7
TVA.....	4.3	5.3	+1.0
Alternate fuels.....	0.5	0.9	+0.4
Rail programs.....	0.2	0.1	-0.1
Public housing.....	1.3	1.0	-0.3
Other independent agencies...	1.5	1.7	+0.2
Rural Electrification a/.....	<u>5.3</u>	<u>4.5</u>	<u>-0.8</u>
Subtotal, off-budget direct loans b/.....	<u>16.5</u>	<u>17.2</u>	<u>+0.8</u>
Total, Direct Loans.....	56.4	49.0	-7.4

a/ Includes both REA direct loans and REA loans financed through FFB.

b/ Adjusted for double counting of loan assets.

- 2) There was some slippage in the loan guarantee area, mainly as a result of large increases in FHA and VA housing guarantees related to the expected recovery in home loan mortgage demand.

MAJOR CHANGES IN FEDERAL CREDIT: 1982-1983 (continued)

	<u>1982</u>	<u>1983</u>	<u>Change</u>
<u>Guaranteed Loans</u>			
Biomass.....	0.7	---	-0.7
FHA mortgage insurance.....	28.6	35.0	+6.4
Rural Development.....	0.6	---	-0.6
Student loans.....	9.5	10.3	+1.4
Public housing.....	18.3	19.8	+1.5
Mortgage insurance.(VA).....	19.5	22.5	+2.9
SBA.....	3.2	2.9	-0.3
Transportation.....	0.9	0.6	-0.3
TVA.....	4.3	5.3	+1.0
Other independent agencies.....	<u>1.5</u>	<u>2.0</u>	<u>+0.5</u>
Total, guaranteed loans.....	<u>87.1</u>	<u>98.4</u>	<u>+11.3</u>
Total Credit Budget.....	143.4	147.3	+3.9
Memorandum: Secondary guaranteed loans			
SLMA.....	0.7	---	-0.7
GNMA.....	<u>48.0</u>	<u>38.4</u>	<u>-10.3</u>
Total.....	48.7	38.4	-10.3

- 3) There was also some slippage in the area of government-sponsored enterprises, mainly Freddie Mac and Fannie Mae. Expanded lending by these agencies is geared toward added liquidity in the mortgage sector during 1982, but this trend also underscores the urgency of future policy actions to permit these agencies full independence from the Federal government.

**MAJOR CHANGES IN NET LENDING
BY GOVERNMENT-SPONSORED ENTERPRISES
(in billions of dollars)**

	<u>1981</u>	<u>1982</u>	<u>Change from 1981</u>	<u>1983</u>	<u>Change from 1982</u>
Student Loan Marketing Association.....	2.1	1.6	-0.5	1.4	-0.2
Federal National Mortgage Association.....	4.1	12.6	+8.5	12.5	-0.1
Farm Credit Administration.....	10.9	11.9	+1.0	13.2	+1.3
Federal Home Loan Banks.....	20.5	4.6	-15.9	5.0	+0.4
Federal Home Loan Mortgage.....	<u>0.3</u>	<u>20.9</u>	<u>+20.6</u>	<u>23.4</u>	<u>+2.4</u>
Total, Government-Sponsored Enterprises <u>1/</u>	36.9	51.5	+14.6	55.5	+4.0

1/ These figures include some double-counting of loans between Government-sponsored enterprises, and do not adjust for enterprise purchases of loans guaranteed by the Federal Government.

- 4) Pulling all the pieces together, the Federal absorption rate is projected to rise significantly in 1982 and 1983, averaging 42.4% for the two year period, 6.9 percentage points above the 35.5% absorption rate of the 1980-81 period. Most of the increase for 1982-83 comes from direct Federal borrowing (on-and off-budget), which is estimated to rise by \$36.1 billion in 1982, an increase of 45.5%. Of course, all estimates are preliminary and will undoubtedly be revised during the course of the year.

**Borrowing Under Federal Auspices:
Absorption of Domestic Credit Market Funds
(Fiscal years; in billions of dollars)**

	Five-Year Averages					1980	1981	1982*	1983
	1955-59	1960-64	1965-69	1970-74	1975-79				
Total funds raised in domestic credit markets 1/	35.5	50.8	80.6	148.6	301.7	342.5	407.8	456.7	515.5
Federal borrowing	2.1	4.5	6.4	13.0	56.8	70.5	79.3	115.4	108.1
Net guaranteed loans	4.0	4.3	5.1	13.9	13.6	31.6	28.0	44.0	46.1
Net government-sponsored enterprise borrowing .	0.4	0.7	1.0	5.0	12.6	21.4	34.8	46.0	50.1
Total funds raised under Federal auspices	6.5	9.5	12.4	31.9	83.0	123.5	142.1	206.0	204.2
Federal absorption rate	18%	19%	15%	21%	28%	36%	35%	45.1	39.1

1/ Funds raised by non-financial sectors, excluding equities.
Source: Federal Reserve Board Flow of Funds

* OMB estimates.

B) Analytical Points of Interest

- 1) Programmatic expansion since the mid 1970's increasingly has occurred in the off-budget area rather than the on-budget area. As the following table suggests, outlays for off-budget entities and government-sponsored enterprises have exploded since 1977. In 1982 these outlays are projected to reach \$69.3 billion in unreported spending. In addition, if loan guarantees are included in the list of unreported outlays, then the total jumps by \$11.3 billion to \$80.6 billion. At a time when official Washington is attempting to convince the public of the new theme of fiscal restraint, this off-budget activity represents a glaring contradiction.

**COMPARISON OF OUTLAYS FOR THE BUDGET,
OFF-BUDGET FEDERAL ENTITIES,
AND GOVERNMENT-SPONSORED ENTERPRISES**
(fiscal years; in billions of dollars)

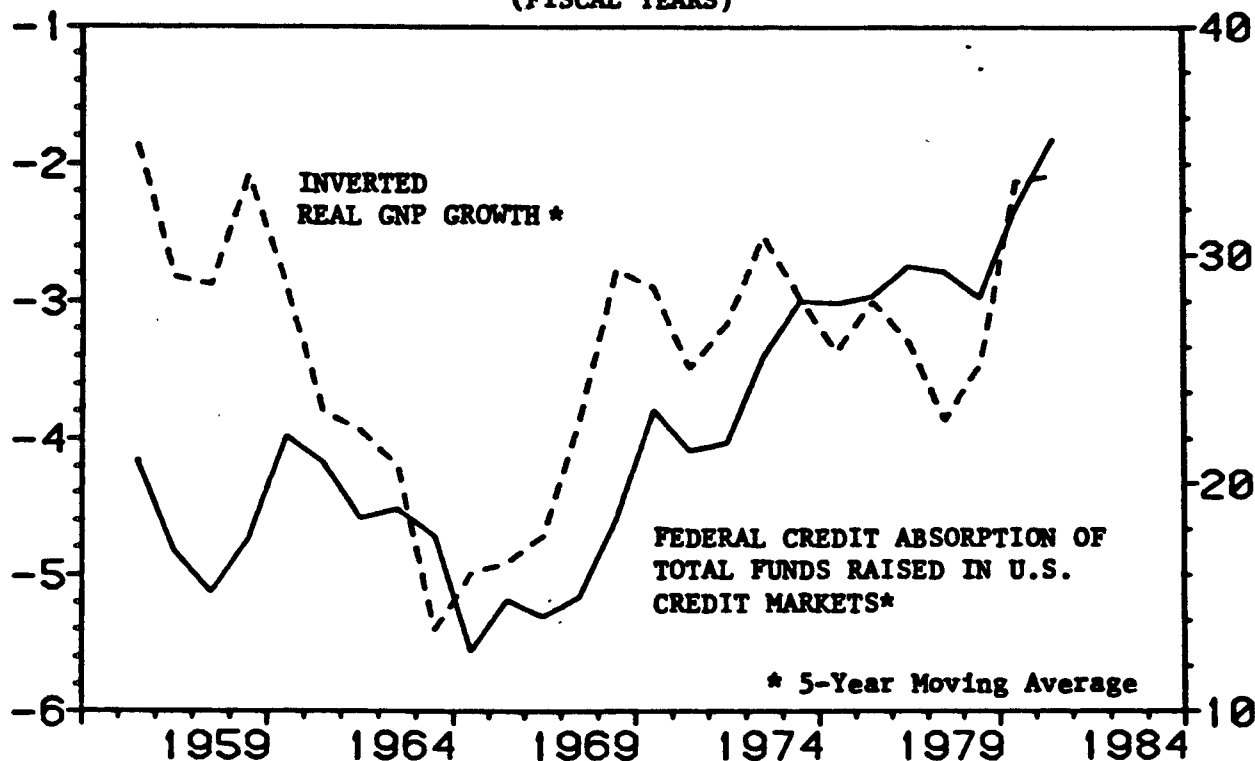
	<u>Federal Government</u>			<u>Government-</u>
	<u>Off-Budget</u>			<u>Sponsored</u>
	<u>Budget</u>	<u>Federal Entities</u>	<u>Total</u>	<u>Enterprises</u>
1970.....	195.7	---	195.7	9.6
1971.....	210.2	---	210.2	*
1972.....	230.7	---	230.7	4.4
1973.....	245.6	0.1	245.7	11.4
1974.....	267.9	1.4	269.4	14.5
1975.....	324.2	8.1	332.3	7.0
1976.....	364.5	7.3	371.8	4.6
TQ.....	94.2	1.8	96.0	2.3
1977.....	400.5	8.7	409.2	9.7
1978.....	448.4	10.4	458.7	24.5
1979.....	491.0	12.5	503.5	25.9
1980.....	576.7	14.2	590.9	25.3
1981.....	657.2	21.0	678.2	33.4
1982 estimate.....	725.3	19.7	745.0	49.6
1983 estimate.....	757.6	15.7	773.3	52.9
1984 estimate.....	805.9	14.3	820.2	<u>1/</u>
1985 estimate.....	868.5	11.0	879.4	<u>1/</u>

* \$50 million or less.

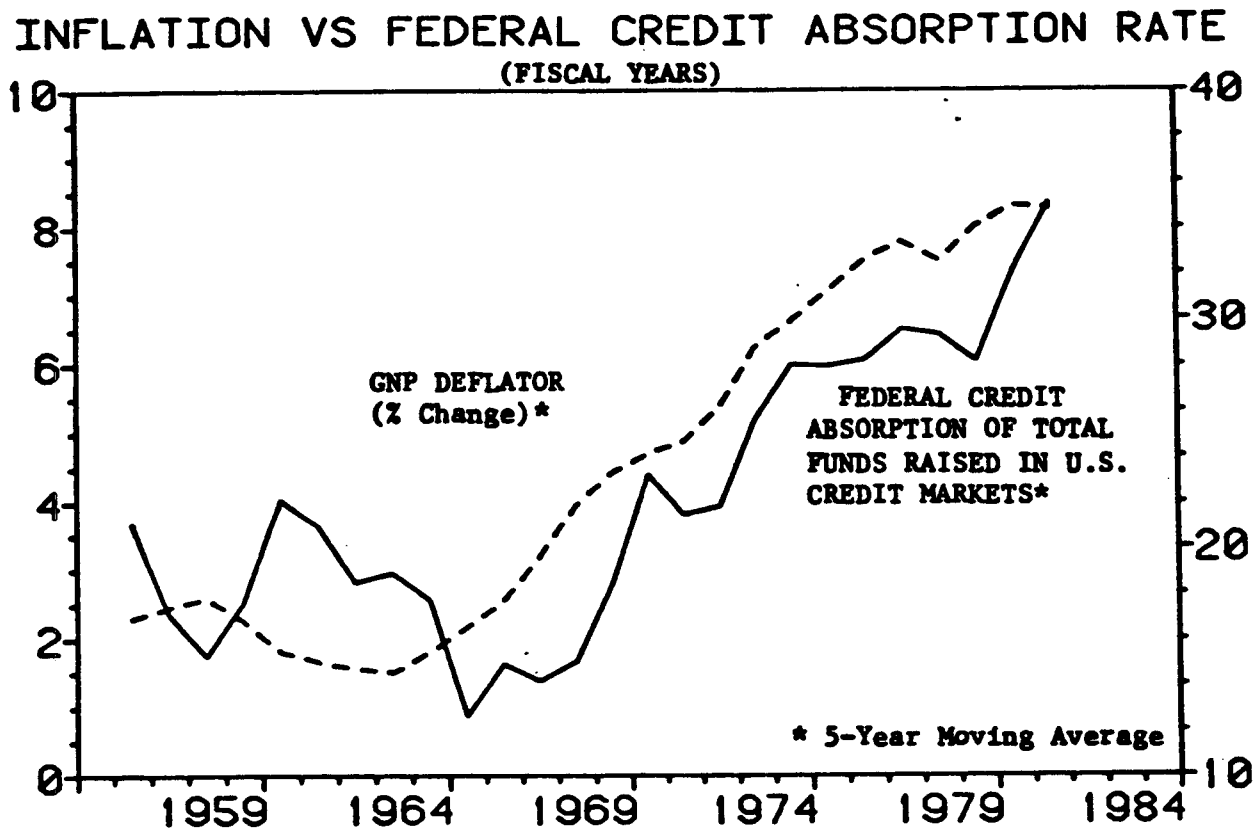
1/ Not available.

- 2) With the continued increase of on- and off-budget financing requirements, the outlook for economic growth is clouded. The consumption of private capital by the government, nearly always for less productive purposes than the profit-oriented private sector, has historically been closely related to trends in the growth of real GNP.

REAL GNP GROWTH VS FEDERAL CREDIT ABSORPTION RATE (FISCAL YEARS)

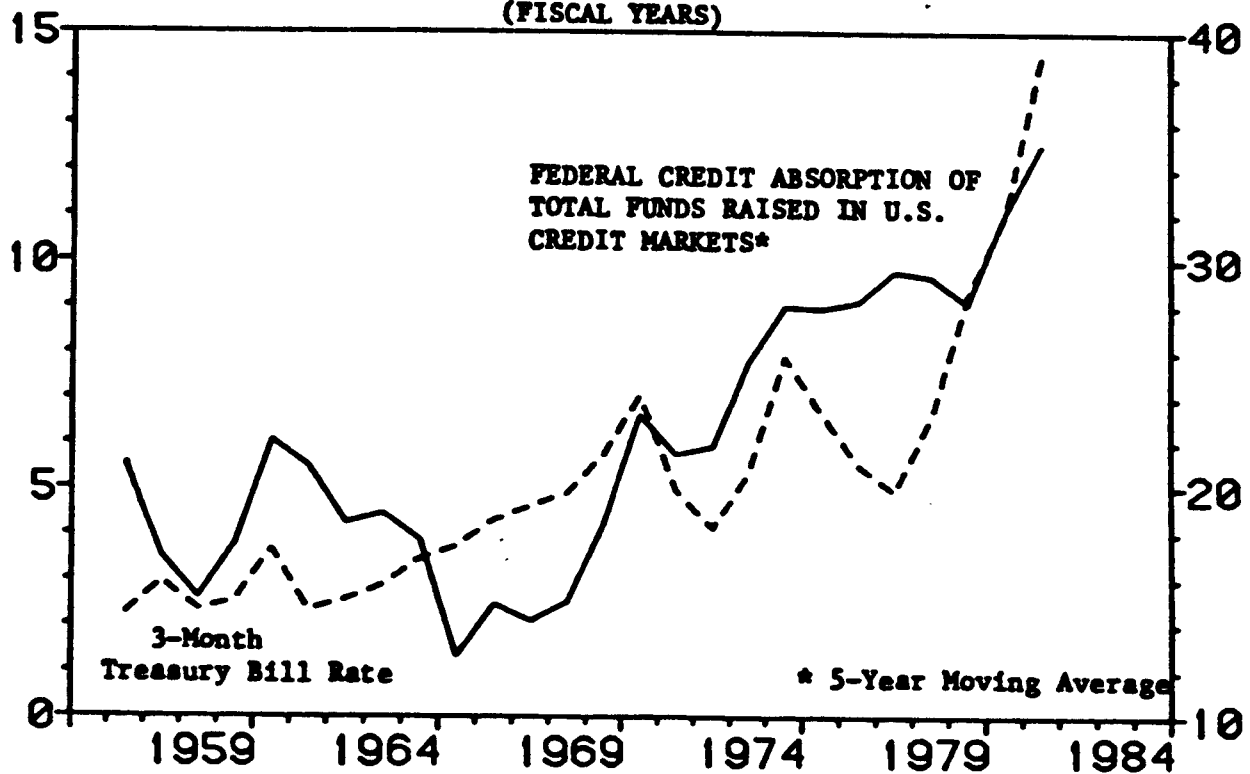


- 3) Over time, growing Federal credit absorption has been closely related to rising money supply growth and inflation.



4) And finally, the interest rate influence is unmistakable.

INTEREST RATES VS FEDERAL CREDIT ABSORPTION RATE (FISCAL YEARS)



C. Future Agenda of the Working Group

Against the backdrop of rising Federal credit absorption and widespread concern over the outlook for inflation, interest rates and economic growth, the working group agenda during the months ahead will be focusing on the following:

- 1) Federal Financing Bank (FFB)
- 2) Government National Mortgage Association (GNMA)
- 3) Credit subsidies
- 4) Farm Credit Systems (FCS)

On Wednesday, March 17, the working group met to discuss the FFB. A paper on this issue is now being revised, and it is expected that the views of the working group on this matter will be presented to the Council during the next week.